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**THE INFLUENCE OF INTEREST RATES ON ITS
ALTERNATIVES IN THE UNITED KINGDOM ISLAMIC HOME
FINANCING**



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UUM
Universiti Utara Malaysia

**DOCTOR OF PHILOSOPHY
UNIVERSITI UTARA MALAYSIA
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**THE INFLUENCE OF INTEREST RATES ON ITS ALTERNATIVES IN THE
UNITED KINGDOM ISLAMIC HOME FINANCING**



By
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Universiti Utara Malaysia

**Thesis Submitted to
Othman Yeop Abdullah Graduate School of Business,
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in Fulfilment of the Requirement for the Degree of Doctor of Philosophy**



Pusat Pengajian Perniagaan Islam
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ABSTRAK

Perbankan dan kewangan Islam telah menunjukkan kepentingan yang luar biasa sejak institusi kewangan Islam pertama ditubuhkan sekitar lima dekad yang lalu. Namun, perbankan yang dikatakan tanpa faedah ini masih belum dapat membuktikan bahawa institusi ini bebas daripada faedah. Kajian ini memberi tumpuan kepada harga sewa, harga rumah dan kadar sewa sebagai alternatif kepada penanda aras kadar faedah dalam pembiayaan rumah Islam. Oleh itu, objektif kajian ini adalah untuk meneliti jangka panjang dan jangka pendek serta hubungan sebab akibat antara pemboleh ubah makro ekonomi dan setiap tiga pemboleh ubah bebas. Kajian ini menggunakan data suku tahunan United Kingdom dari tahun 2000 hingga 2016. Di samping itu kajian ini menggunakan Autoregressive Distributed Lags (ARDL), Granger causality dan Model Pembetulan Ralat Vektor (VECM) untuk mencapai matlamat kajian. Keputusan kajian menunjukkan bahawa kadar faedah mempengaruhi ketiga-tiga pemboleh ubah bebas pada hubungan jangka panjang dan jangka pendek. Seterusnya, keputusan menunjukkan terdapat hubungan sebab akibat antara pemboleh ubah. Oleh itu, hasil keputusan menunjukkan bahawa kebergantungan pada kadar faedah menyebabkan ketidakstabilan kepada harga sewa, harga rumah, dan kadar sewa. Penemuan selanjutnya mencadangkan bahawa kuasa pasaran harus menentukan harga sewa dan rumah serta kadar sewa di pasaran perumahan dan bukan bergantung pada kadar faedah. Berdasarkan alternatif ini, pembiayaan rumah boleh dikaitkan dengan permintaan dan penawaran pasaran perumahan serta adalah lebih adil untuk pelanggan kerana berdasarkan sifat fizikal harta tersebut. Bagi institusi kewangan, risiko kredit dikurangkan kerana harta tersebut boleh disewakan berdasarkan nilai pasaran. Pada masa yang sama menjadi lebih mampan untuk pelanggan membayar balik pinjaman mereka.

Kata kunci: Pembiayaan rumah Islam, pemboleh ubah makroekonomi, ARDL dan VECM

ABSTRACT

Islamic banking and finance has gained phenomenal significance since the first Islamic financial institution was established around five decades ago. However, the supposedly interest-free banking is yet to prove itself as being entirely free from the interest rate. This study focused on the rental price, house price and rental rate as possible alternatives to the interest rate benchmarking in Islamic home financing. Therefore, the objectives of the study were to investigate the long-run and the short-run as well as the causal relationship between the macroeconomic variables and each of the three dependent variables. By using the United Kingdom quarterly data for the period 2000-2016, the study employed the Autoregressive Distributed Lags (ARDL) method, Granger causality, and the Vector Error Correction Model (VECM) multivariate causality to achieve these objectives. The final results show that rental rate is free from the influence of interest rates in both the long-run and the short-run. The results further recommend rental rate as the best alternative to interest in Islamic home financing. Therefore, the outcome of the result establishes that relying on the interest rates destabilizes the alternatives to the interest rate. The findings further suggest that the market forces should determine the rental and house prices as well as the rental rate in Islamic home financing instead of relying on the interest rate. By employing these alternatives, home financing can be linked to the demand and supply of the housing market and thus is fairer to the customers as they are based on the physical attributes of the property. For the financial institutions, credit risk is mitigated as the property can be leased out based on the market value and at the same time becomes more sustainable for financing their clients.

Keywords: Islamic home financing, interest rates, ARDL and VECM.

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GLOSSARY OF TERMS

Amanah	Trust
Bay al-inah	Back-to-back sale (Indirect interest loan)
Bay' Bithaman Ajil	Sales for deferred payment
Fatawa	Shari'ah verdict
Ijarah	Leasing
Hima	Private Pasture
Manzil	Dwelling
Murabahah	Cost plus arrangement
Musharakah Mutanaqisah	Diminishing Partnership
Riba	Usury or Interest
Sallallahu Alaihi Wasallam	Peace be upon Him
Shari'ah	Islamic law



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LIST OF ABBREVIATIONS

Abbreviation	Full Meaning
ADF	Augmented Dickey-Fuller
AICAkaike	Akaike Information Criteria
ARCH	Auto-Regressive Conditional Heteroskedasticity
ARDL	Autoregressive Distributed Lags
ARIMA	Autoregressive Integrated Moving Average
ARIMAX	Autoregressive Integrated Moving Average with Exogenous
BBA	Bay' Bithaman Ajil
BIMB	Bank Islam Malaysia Berhad
CEE	Central Eastern Europe
CUSUM	Cumulative Sum of Recursive Residuals
CUSUMSQ	Cumulative Sum of Squares of Recursive Residuals
DF	Dickey-Fuller
EXR	Exchange Rate
GARCH	Generalized Autoregressive Conditional Heteroskedasticity
GDP	Gross Domestic Product
HPI	House Price Index
HQIC	Hanan Quinn Information Criteria
HSBC	Hong Kong and Shanghai Banking Corporation
IBR	Islamic Bank Rate
IMF	International Monetary Funds
INF	Inflation Rate
IRF	Impulse Response Function
LM	Lagrange Multiplier
LTIR	Long-Term Interest Rate
MM	Musharakah Mutanaqisah
OECD	Organization for Economic Co-operation and Development
PP	Phillips-Perron
RESET	Ramsey's Regression Equation Specification Error Test
RMB	Ren-Min-Bi
RPI	Rental Price Index
SHPI	Share Price Index
SIC	Schwarz Information Criteria
STIR	Short-Term Interest Rate
UECM	Unrestricted Error Correction Model
VAR	Vector Autoregressive
VECM	Vector Error Correction Model

CHAPTER ONE

INTRODUCTION

1.1 Introduction

This chapter highlights the general introduction of the thesis. It presents the background and motivation of the research. The section further discusses the problem of the study from which research questions and objectives are generated. The rest of the chapter consists of the significance and the scope of the study. The last section presents the organization of the thesis.

1.2 Background of the Study

Traditionally, the housing market contributes significantly towards providing the individual with a shelter that consists of basic protection. Shelter (housing) is ranked as the third necessity of a human being (Qureshi & Hidayat, 2016) after food and clothing. Housing could either be through renting or purchasing a house (Clark, 2002). Both renting and buying property consume a lot in the household income. Therefore, it becomes difficult for an individual to own a house without support from the financial institutions. These financial institutions are dominated by commercial banks that use interest-based financing systems. Conventional financing is associated with the interest rate (Brissimis & Vlassopoulos, 2009). Hence, many scholars have criticized financing that is interest based even from the view of well-known scholars (such as Fisher, 1930; Friedman, 1969 and Simons, 1948). The scholars above regard interest-based financing as fundamentally unsound and insecure. The world has experienced many financial crises before the recent global economic crisis as a result of financing based on interest (Chapra, 2009 and

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APPENDICES

Appendix A Variable Graphs

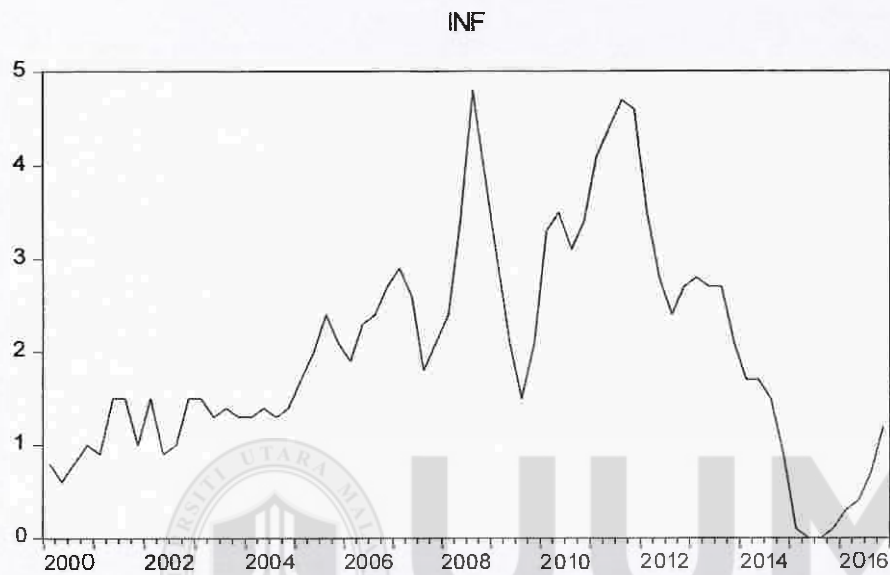


Figure 1.1:
Consumer Price Annual Inflation

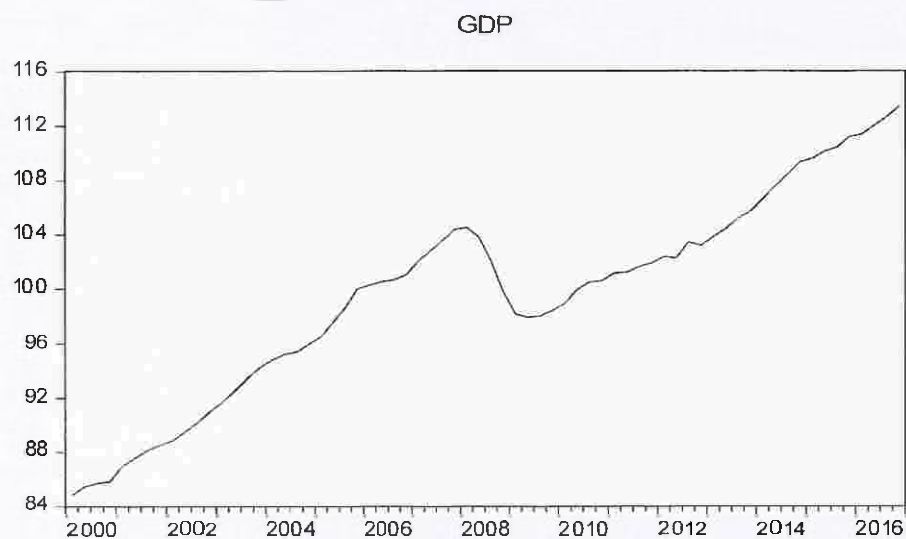


Figure 1.2:
Gross Domestic Products

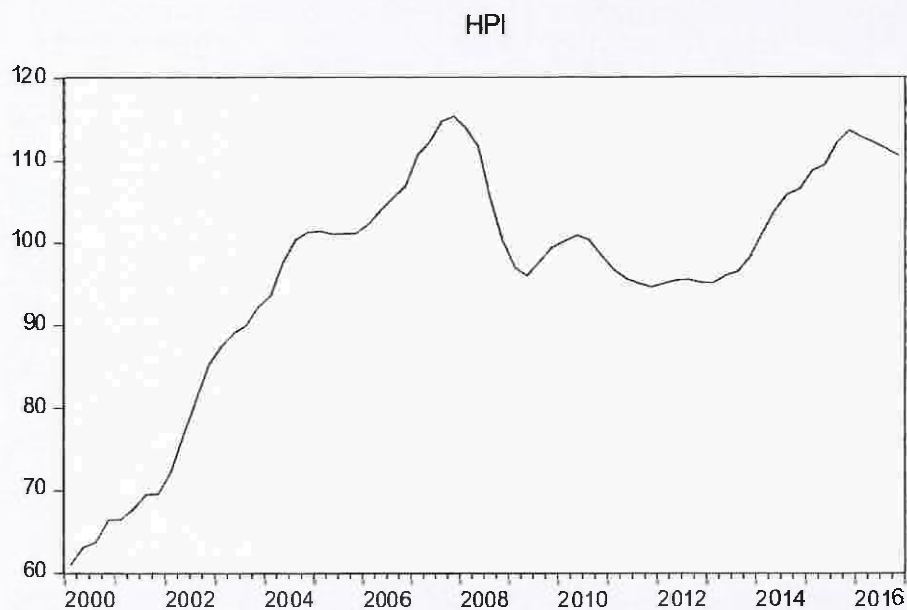


Figure 1.3:
House Price Index

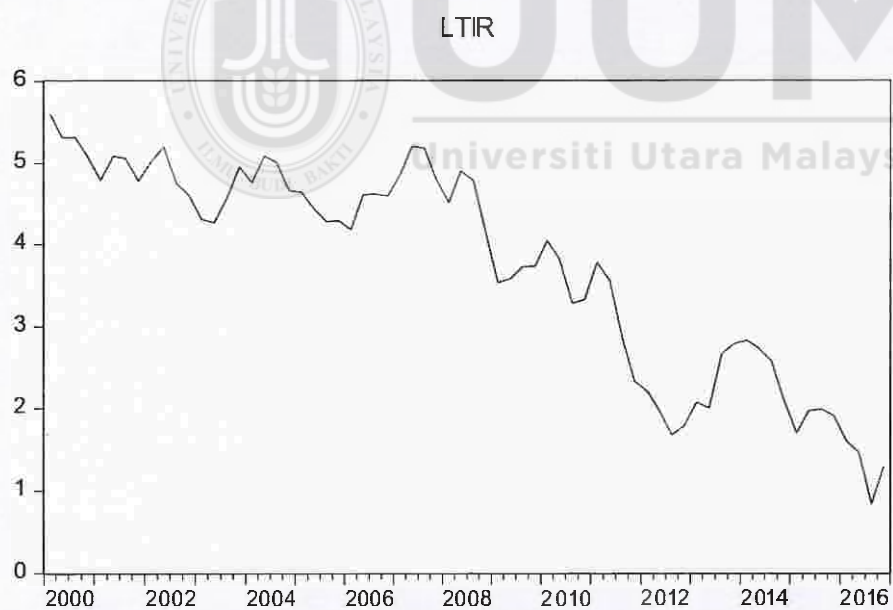


Figure 1.4:
Long-Term Interest Rate

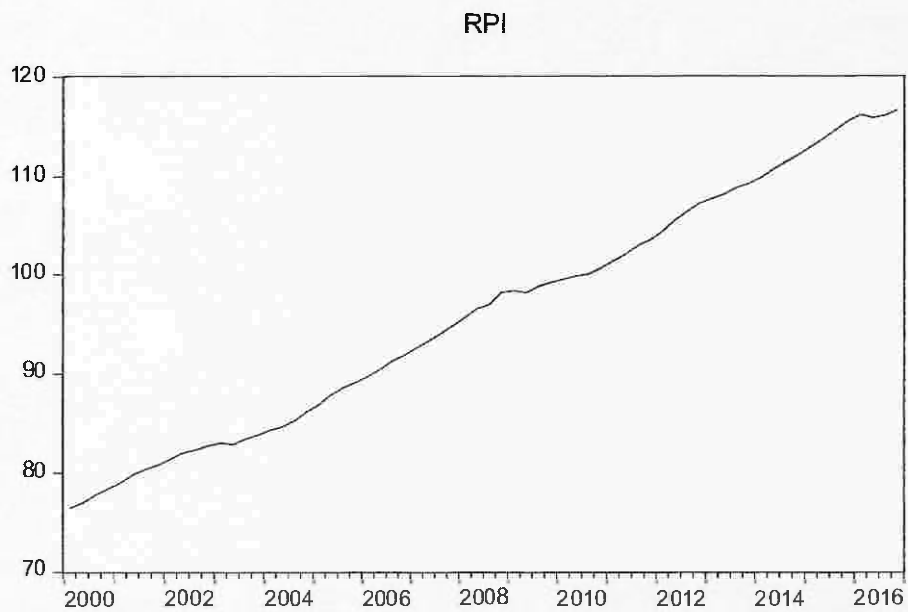


Figure 1.5:
Rental Price Index

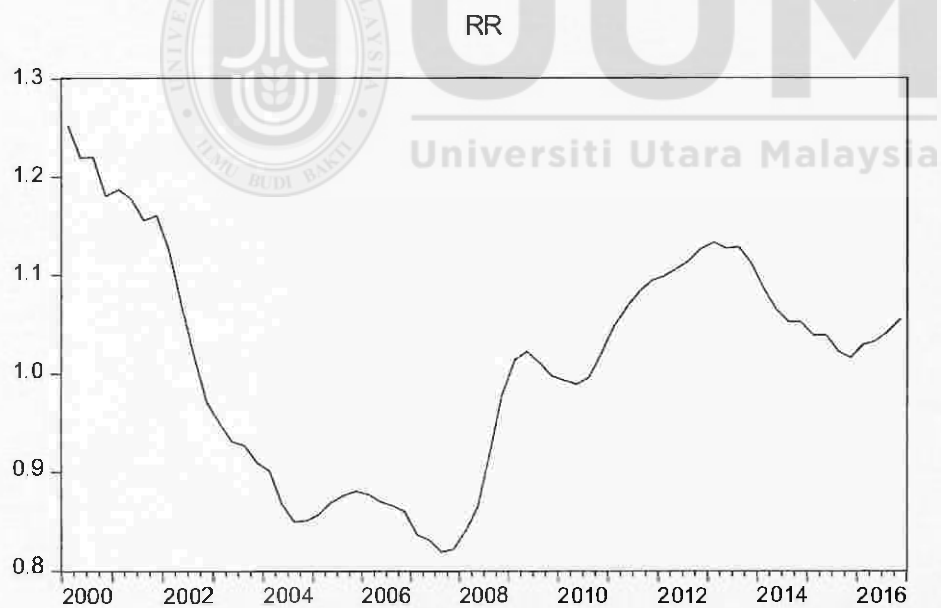


Figure 1.6:
Rental Rate

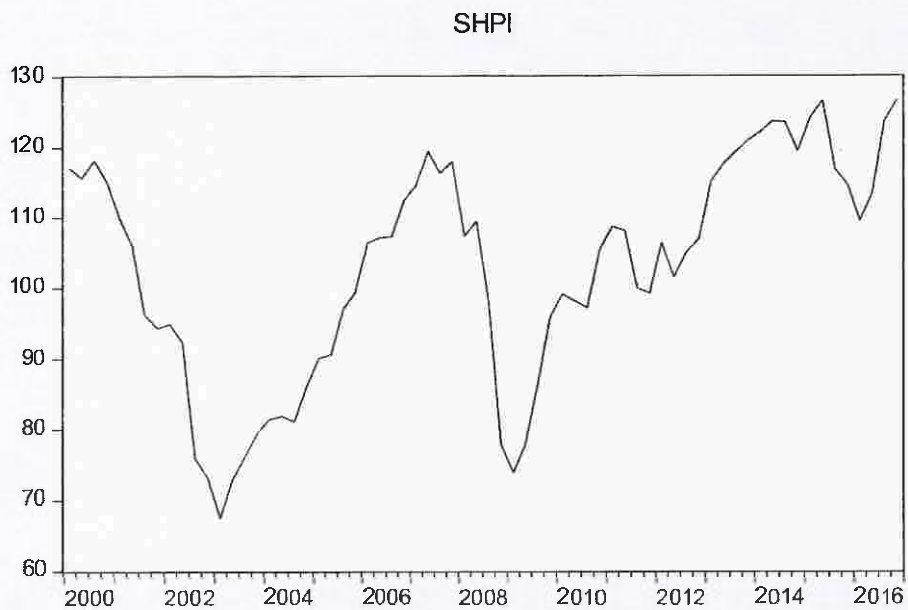


Figure 1.7:
Share Price Index

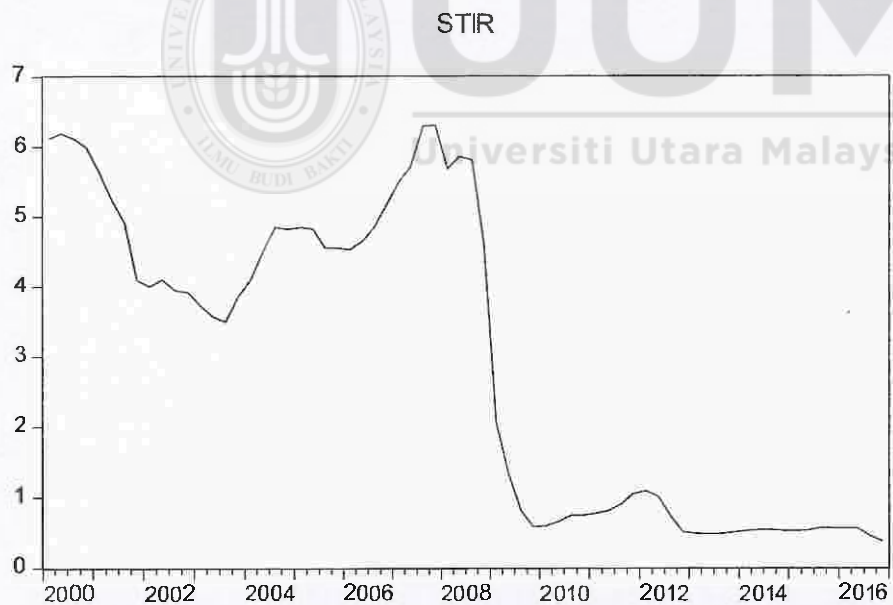


Figure 1.8:
Short-Term Interest Rate

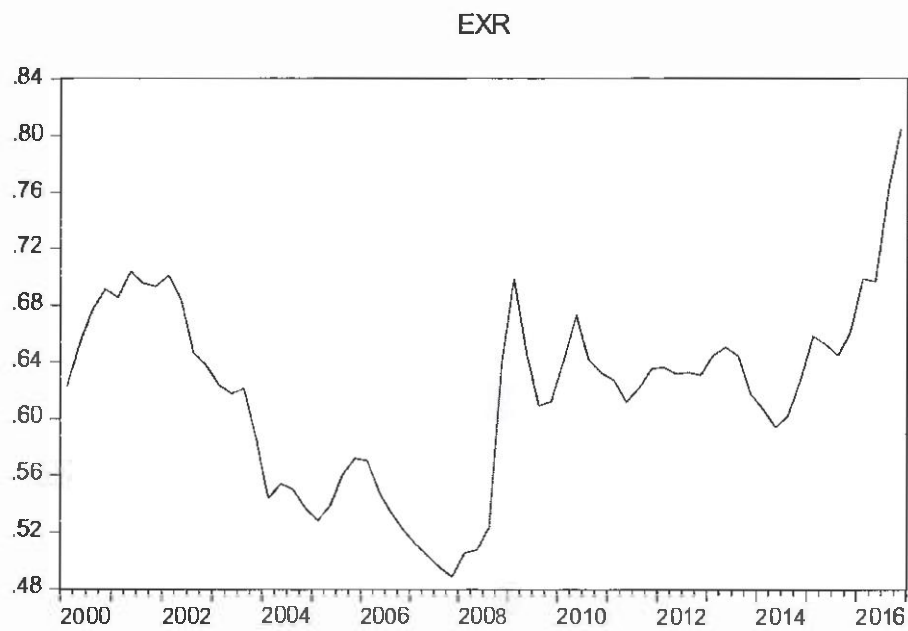


Figure 1.9:
Exchange rate Pound Starlings per US Dollar



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Appendix B
CUSUM and CUSUMSQ

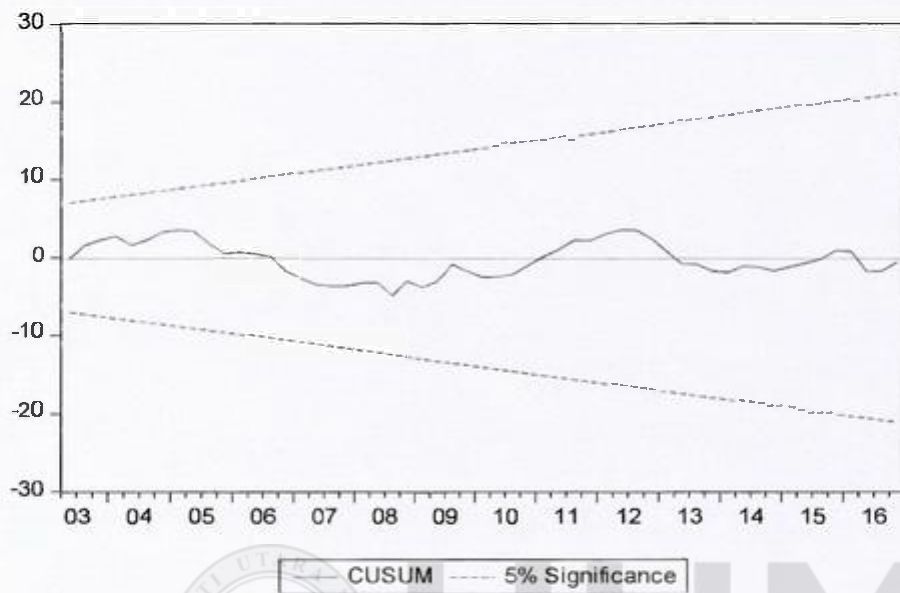


Figure 5.1:
CUSUM for Rental Price index Model

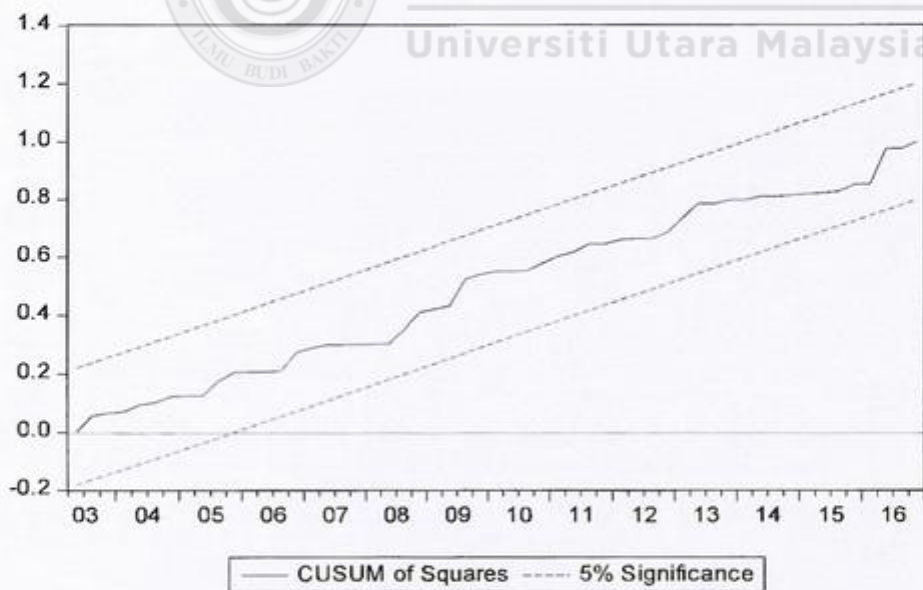


Figure 5.2:
CUSUMSQ for Rental Price index Model

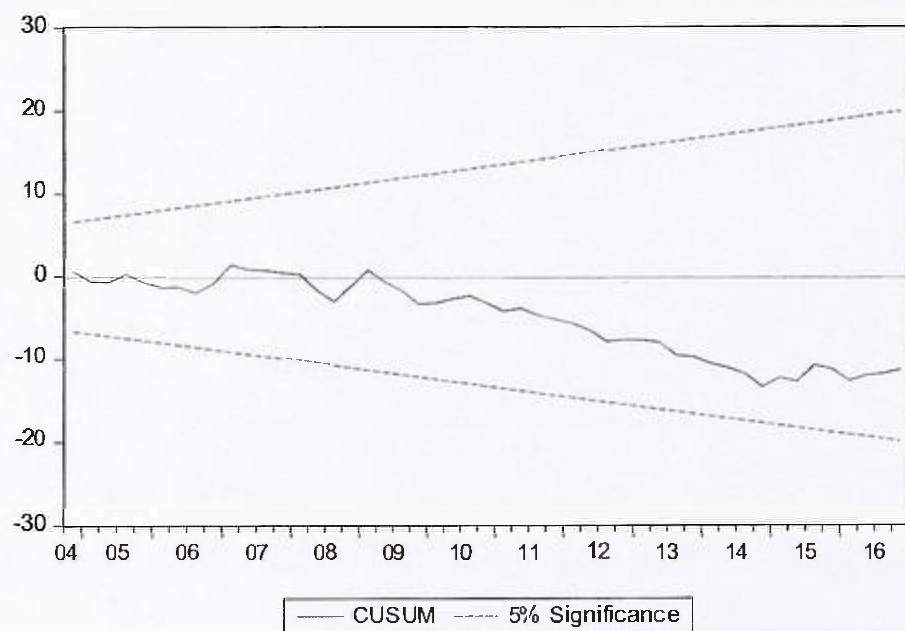


Figure 5.3:
CUSUM for House Price index Model

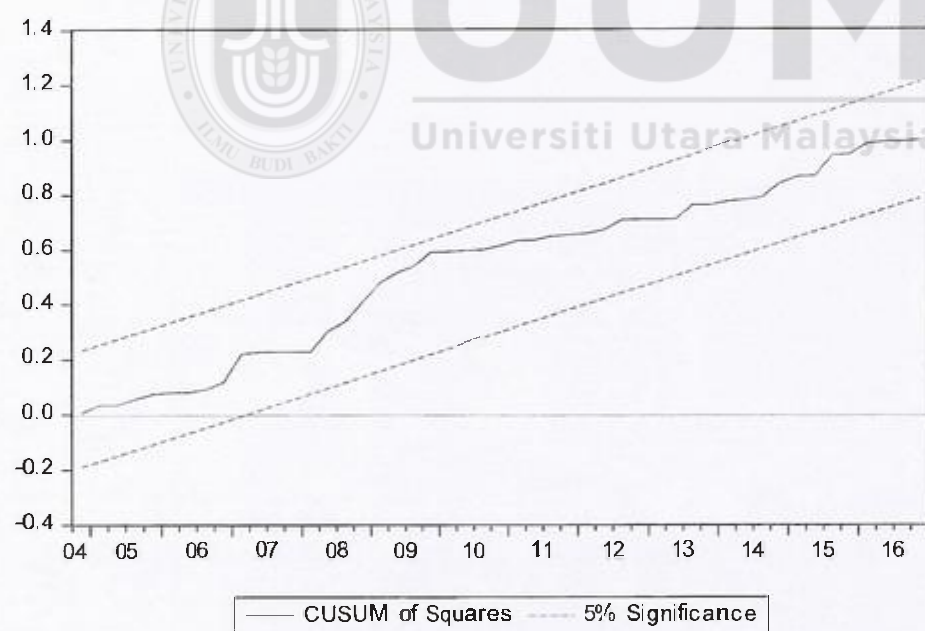


Figure 5.4:
CUSUMSQ for House Price index Model

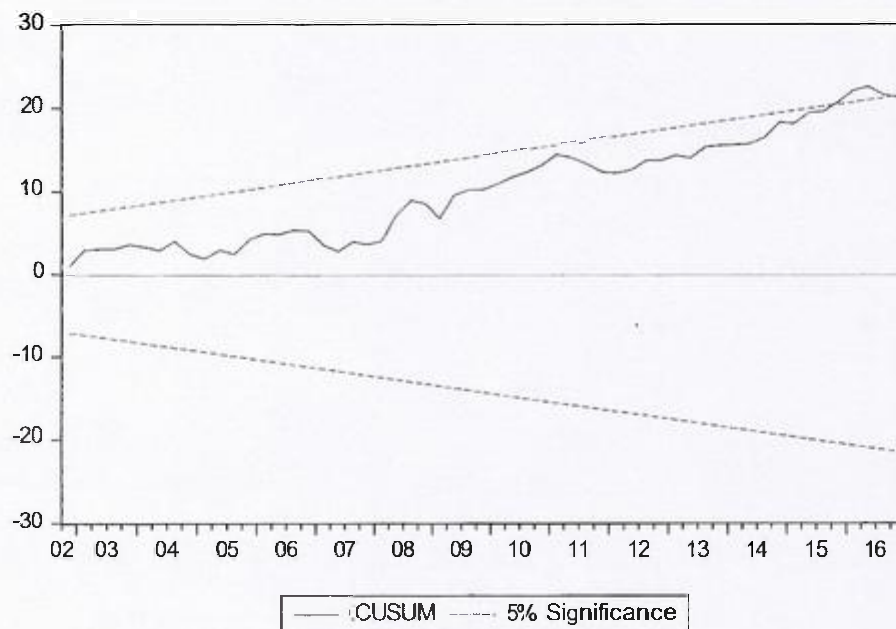


Figure 5.5:
CUSUM for Rental Rate Model

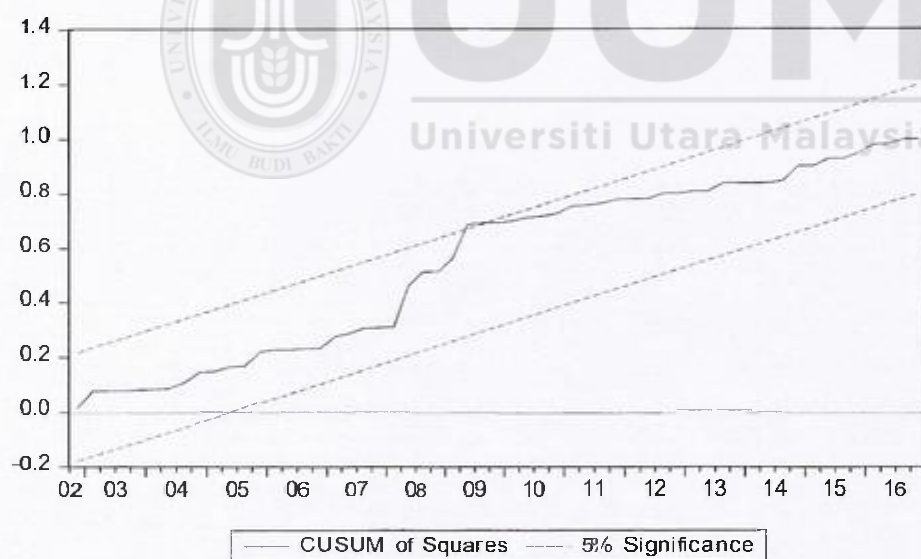


Figure 5.6:
CUSUMSQ for Rental Rate Model

Appendix C

Alburaq

Please find below our range of products (offered in conjunction with Bristol & West unless otherwise stated) and how the rent is calculated. For those who can provide proof of income - being fully employed or who are self employed with a minimum of 2 years certified accounts:

Discount until March 2008

Product Code DR011 (purchase) or DR012 (refinance)

Rent is calculated 6 monthly, on the basis of 6 MONTH LIBOR* (on the 1st September and 1st March) minus a discounted margin of 0.07% (until 31st March 2008), then reverting to a fixed margin of 1.35% (guaranteed for the remainder of term)

Current pricing is 6 Month LIBOR* (5.09 %) - 0.07% = 5.02%

Arrangement Fee £299

Profit margin is discounted at each rent review until March 008

Additional lump sum payments can be made prior to each rent review.

Standard product

A flexible option whereby the rent will change more frequently but where you can make additional acquisition payments every 6 months, (or earlier in the case of the very first rental period). See page 9 of our brochure for more details.

Product Code VR001 (purchase) or VR002 (refinance)

Rent is calculated 6 monthly, on the basis of 6 MONTH LIBOR (on the 1st September and 1st March) + a fixed margin of 1.09% (guaranteed for the entire term).

Current pricing is 6 Month LIBOR (5.09%) + 1.09% = 6.18%

Arrangement Fee £299.

Features: Additional lump sum payments can be made prior to each rent review.

Fees Assisted Discounted Product**Product Code DR009 (purchase) or DR010 (refinance)**

Rent is calculated 6 monthly, on the basis of 6 MONTH LIBOR* (on the 1st September and 1st March) + a discounted margin of 0.09% (until 30th September 2007), then reverting to a fixed margin of 1.29% (guaranteed for the remainder of term)

Current pricing is 6 Month LIBOR* (5.09 %) + 0.09% = 5.18%

Arrangement Fee £299 – Refunded on Completion

Solicitors charges up to £355 +VAT - Refunded on Completion

Additional lump sum payments can be made prior to each rent review.

1 Year Fixed Rate Product**Product Code FR005 (purchase) or FR006 (refinance)**

Rent is fixed until 30th September 2007, thereafter, rent is calculated 6 monthly, on the basis of 6 MONTH LIBOR (on the 1st September and 1st March) fixed at 4.99% (until 30th September 2007), then reverting to a fixed margin of 1.19% (guaranteed for the entire term).

Current pricing= 4.99%

Arrangement Fee £299.

Features: Additional lump sum payments can be made prior to each rent review.

Please note that with all products, you can pay the entire amount at any time without penalty. There is no minimum amount when making additional lump sum payments prior to each rent review, and there is no charge in doing so.

*LIBOR - means the London Inter-bank Offered Rate, and is used as a benchmark for the pricing of rent.

LIBOR rates are set daily and can be easily obtained in financial newspapers or on the internet. Our Shariah Supervisory Committee have permitted the use of LIBOR to calculate rent, provided that

Disclaimers: the information given above needs to be verified with Alburaq or its dedicated intermediaries.

We do not accept any responsibility for inaccuracies in the information given above.

Source: <http://www.islamicmortgages.co.uk>